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IN THE

SUPREME COURT

OF THE

UNITED STATES

October Term, 1937.

No. 406.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

THOMAS A. O'DONNELL,

ON PETITION FOR A WRIT OF CERTIORARI TO THE [illegible] CIRCUIT COURT OF APPEALS FOR THE [illegible] CIRCUIT.

BRIEF FOR THE RESPONDENT IN OPPOSITION

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

BRIEF FOR THE RESPONDENT IN OPPOSITION.

Opinions Below

The opinion of the Board of Tax Appeals [R. 47-52] is reported in 32 B. T. A. 1277. The opinion of the Circuit Court of Appeals is not yet reported.

Jurisdiction

The judgment of the Circuit Court of Appeals was entered June 14, 1937. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

Question Presented

Is a taxpayer, who is entitled to receive one-third of the net profits from the development and operation of oil properties, entitled to a deduction for depletion in computing his net taxable income?

Statutes Involved

The statutes involved will be found in the Appendix, *infra*, pp. 11, 12.

Statement of the Case

Thomas A. O'Donnell, an oil operator, owned one-third of the capital stock of the San Gabriel Petroleum Company, which he sold to the Petroleum Midway Company, Ltd., by written contract on January 9, 1918. [R. 44.]

As consideration for such stock Midway agreed to pay O'Donnell one-third of the net profits from the development and operation of the properties enumerated in leases then owned by the San Gabriel Company. [R. 78.] Midway agreed to acquire all of the assets of the San Gabriel Company and to dissolve it. [R. 79.]

The contract further provided that in ascertaining net profits, which was to be done quarterly, "there shall be deducted from the gross receipts, in addition to other deductions, a sum of money equal to six (6%) per cent per annum, figured on the net advances made by second party (Midway Company) for the payment of the debts of said San Gabriel Petroleum Company and for the development of its properties, * * *" [R. 79.]

In accordance with the contract, the Midway Company (name since changed to California Petroleum Corpora-

tion of California) acquired all of the assets of the San Gabriel Company and dissolved it, and developed and operated the oil properties thus acquired, and paid respondent one-third of the net profits to August 4, 1926. [R. 44-45.] (Subsequent payments were made to Mrs. O'Donnell [R. 46], which the court below held were taxable to her.)

The petition to the Board involved O'Donnell's right to deduct percentage depletion on the payments received by him under the above contract. [R. 22.] The Board allowed the claimed depletion. The Circuit Court of Appeals affirmed the Board.

Argument

Despite the Government's constant attempt to limit depletion allowances to only those owning legal title of the mineral lands, this Honorable Court has consistently held that the statutory allowance "is to be made to everyone whose property right and interest therein have been depleted by the extraction and disposition of the mineral." (*Lynch v. Alworth-Stephens Co.*, 267 U. S. 364.) Subsequent to this decision the Government took the position that "depletable interest" must be some form of estate in land, leasehold or freehold, as distinguished from contractual rights to receive payments measured by the production of oil. However, this Honorable Court following the doctrine laid down in the *Alworth-Stephens Co.* case held that the depletion deduction should be allowed to all those having an "economic interest" in the mineral pool.

Palmer v. Bender, 287 U. S. 551, 53 S. Ct. 225, 77 L. Ed. 489.

This Honorable Court has also held that a lessor was entitled to the depletion deduction on a bonus received prior to production (*Murphy Oil Company v. Burnet*, 287 U. S. 299, 53 S. Ct. 161, 77 L. Ed. 318); and also that a lessor is entitled to a depletion allowance on bonus and royalties although by the local law ownership of the minerals in place passes from the lessor upon the execution of the lease.

Burnet v. Harmel, 287 U. S. 103, 53 S. Ct. 74, 77 L. Ed. 199;

Bankers Pocahontas Coal Company v. Burnet, 287 U. S. 308, 53 S. Ct. 150, 77 L. Ed. 325.

Petitioner, nevertheless, contends that the respondent did not acquire an economic interest in the oil in place. The Board found that respondent sold capital stock of the San Gabriel Petroleum Company to the Petroleum Midway Company, Ltd. and the latter agreed to pay respondent one-third of the net profits received by it from the development and operation of the properties enumerated in the leases. [R. 78.] Respondent's right to receive one-third of the net profits from the development and operation of the properties was certainly an economic interest; it was a source from which respondent derived income. Respondent's right to receive any money depended upon production of oil. Certainly, the production of oil exhausted the oil pool and by such exhaustion respondent's property right was depleted. The mineral content certainly was an economic unit, one hundred per cent of which was owned by someone. The Petroleum Midway Company, Ltd. was entitled to only sixty-six and two-thirds per cent of the profits derived from production and respondent was entitled to the balance. Therefore, it is quite evident that

respondent had an economic interest in the mineral and that he is entitled to the depletion deduction.

Petitioner emphasizes the fact that in computing the net profits to be divided between respondent and the Petroleum Midway Company, Ltd. certain stipulated interest payments were to be deducted. The contract [R. 79] does provide that in determining the net profits "there shall be deducted from the gross receipts in addition to other deductions a sum equal to six per cent per annum, figured on the net advances made by second party for the payment of the debts of said San Gabriel Petroleum Company and for the development of its properties, * * *."

Under the contract of January 9, 1918, the Petroleum Midway Company, Ltd. agreed to acquire all the stock of the San Gabriel Petroleum Company and then dissolve it. Naturally, the creditors had to be taken care of and the stipulated interest deducted in determining the net profits from the proceeds was merely a *pro rata* share of respondent's liability as a stockholder. The deduction of interest charges on debts owed by the San Gabriel Petroleum Company as well as interest paid on money used by the Petroleum Midway Company, Ltd. in developing the properties cannot, it is respectfully submitted, change the fact that respondent had an economic interest in the mineral resources. His economic interest was merely diminished by the stipulated interest payments. Certainly the requirement that in determining the net proceeds the stipulated interest be deducted does not in anywise lessen the right respondent had in the mineral resources.

The interest which was to be deducted in determining the net profits was nothing more than additional cost to the respondent of his interest in the mineral resources.

Respondent's right is no different than his right would have been had the San Gabriel Petroleum Company distributed all of its assets in liquidation (which, of course, were oil properties), to its stockholders. The respondent was entitled to one-third of the assets. The result would have been the same if the San Gabriel Petroleum Company had been liquidated and respondent had transferred his one-third interest therein to the Petroleum Midway Company, Ltd. for the same consideration, a right to receive one-third of the net profits from production. In either event the respondent would have had the same economic interest in the oil properties.

Petitioner contends that the gross income from the property belonged to the Petroleum Midway Company, Ltd. by reason of which petitioner now alleges would deny respondent the right to depletion. This begs the question. Under the arrangement the Petroleum Midway Company, Ltd. was not the owner of all the gross proceeds derived from production; it merely had the right to operate the property and before dividing the proceeds to deduct stipulated interest and cost of operation. At all times respondent had an interest in the mineral products—in the gross proceeds—and the amount he was to receive was merely measured by the net proceeds. In any event the amount that respondent received was derived from the production of oil. The amount he received was his gross income and it is that gross income which the statute refers to in determining the amount of the depletion deduction.

The statute contemplates that the total amount of depletion allowed be apportioned between those entitled thereto. The Petroleum Midway Company, Ltd. certainly is not entitled to the full deduction for depletion since it does not

have an economic interest in the full amount derived from the production of oil. It has merely the right to sixty-six and two-thirds per cent, and certainly it would be highly inequitable to give Petroleum Midway Company, Ltd. all the depletion under these circumstances. The revenues of the Government will not be affected if petitioner will follow the requirements of the statute and the principles enunciated and reiterated by this Court on this question.

The mere fact that the contract provided that Midway Company was to pay respondent cash instead of oil does not in any wise change the nature of respondent's interest in the property. This Honorable Court stated in the case of *United States v. Noble,* 237 U. S. 73, 74, 59 L. Ed. 844, that:

> "* * * It is said that the leases contemplated the payment of sums of money, equal to the agreed percentage of the market value of the minerals, and thus that the assignment was of these moneys; but the fact that rent is to be paid in money *does not make it any the less a profit issuing out of the land.* * * *." (Italics supplied.)

This Honorable Court in the case of *Burnet v. Harmel,* 287 U. S. 103, 53 S. Ct. 74, 77 L. Ed. 199, also stated:

> "It is an incident of every oil and gas lease, where production operations are carried on by the lessee, that the ownership of the oil and gas passes from the lessor to the lessee at some time and the lessor is compensated by the payments made by the lessee for the rights and privileges which he acquires under the lease. * * *."

It would appear that anyone is economically interested in property who realizes proceeds from property or has a right, by whatever name called, to realize proceeds. Everyone beneficially interested in oil properties should have depletion on a percentage basis in direct proportion to their income from the property, and this right to depletion should not be denied or transferred to another person by reason of artificial technicalities affecting the title to the property.

Since there is no conflict in the Circuit Courts and since the rule applied by the Ninth Circuit Court of Appeals is in harmony with the decisions of this Honorable Court, there are no grounds for granting the writ. The petition should therefore be denied.

Respectfully submitted,

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APPENDIX

Revenue Act of 1926, c. 27, 44 Stat. 916:

SEC. 204. * * *

(c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—

* * * * * * * * *

(2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

SEC. 214 (a) In computing net income there shall be allowed as deductions:

* * * * * * * * *

(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

* * * * * * * * *

Revenue Act of 1928, c. 852, 45 Stat. 799:

SEC. 23. * * *

(1) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. (For percentage depletion in case of oil and gas wells, see section 114 (b) (3).)

* * * * * * * * *